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In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC. *et al.*,

Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICUS CURIAE*[1]

For more than 100 years, the American Institute of Certified Public Accountants (AICPA) has served as the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies and individuals through firms of all sizes, as solo practitioners, and as employees of companies, government, and academia. Among the AICPA's most important roles is to promote and maintain high professional standards among its members. To this end, the Institute has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by CPAs.

The AICPA also has a strong interest in judicial decisions affecting the scope and bases of accountants' liability under the federal securities laws. To that end, the AICPA has participated as *amicus curiae* in a wide variety of cases, including this Court's most significant securities fraud cases in each of the last three decades: *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1995); *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988); and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The present case, this Court's first foray into the issue of loss causation under the Private Securities Litigation Reform Act of 1995, is of paramount importance to the accounting profession. Loss causation is an indispensable element of the private action available under Section 10(b) of the Securities Exchange Act of 1934, one that helps to separate cases involving genuine injury from those in which disappointed

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[1] The parties' letters of consent to the filing of this brief have been lodged with the Clerk. Pursuant to Rule 37.6 of the Rules of this Court, the AICPA states that no counsel for a party has authored this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief.

investors seek to blame others for the consequences of ordinary market risk. If deployed in the misguided fashion endorsed by the Ninth Circuit, loss causation ceases to protect secondary actors, such as auditors of financial statements, against assuming the role of insurers for investment losses not meaningfully linked to their own actions. It is to highlight both the flaws in the Ninth Circuit's analysis and the serious practical significance of this issue for the hundreds of thousands of certified public accountants nationwide that the AICPA respectfully submits this *amicus* brief.

SUMMARY OF ARGUMENT

The federal securities laws are at once important tools for protecting investors against fraud and potentially dangerous vehicles for coercing unfair settlements from innocent defendants. In 1995, concerned that the balance had tipped too far in favor of vexatious litigation, Congress enacted the Private Securities Litigation Reform Act (PSLRA), which significantly tightened the pleading requirements for securities fraud class actions. Among the most important aspects of the PSLRA was the codification of the judge-made loss causation requirement.

This case presents an important and recurring question regarding that requirement: whether, in a case involving a fraud-on-the-market presumption of reliance, plaintiffs can establish the element of loss causation merely by pleading and proving that a defendant's misrepresentations artificially elevated the price of a security, or whether plaintiffs must further plead and prove that the alleged fraud actually caused a subsequent decline in the value of the investment. In adopting the former position, the Ninth Circuit fundamentally misconstrued the nature and purpose of loss causation as it has now been codified by Congress. The court's decision effectively nullifies loss causation as an independent element of a private cause of action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, and contravenes the plain language of the PSLRA.

In so doing, the court of appeals failed to appreciate the important function that loss causation plays in securities fraud litigation. The loss causation element separates genuine fraud cases from those in which disappointed purchasers are simply looking to recover against a deep pocket defendant whose actions are not meaningfully related to the gravamen of the claim. In the latter circumstances, certified public accountants – often the only solvent defendants left in the wake of a corporate collapse – frequently become the deep pockets of choice. The judgement-oriented standards of the auditing process – together with often misguided expectations about what an audit is intended to accomplish – make it all too tempting to bring CPAs into securities fraud class actions. And, given the realities of such litigation, it can be all too difficult and too costly for them to get out.

In order to preserve the balance that Congress intended, it is therefore essential to ensure that the PSLRA's overriding goal of distinguishing genuine securities fraud claims from bogus ones not be compromised. By failing to take loss causation seriously, the decision below ignores Congress' design and subjects auditors (and other secondary actors, including lawyers and market analysts) to strike suits based on statements that played no role in bringing about the investment loss that plaintiffs suffered. The decision below thereby casts CPAs in a role they were never supposed to play: insuring disappointed investors against losses caused by the actions of others or by the ordinary vicissitudes of the market.

ARGUMENT

I. CONGRESS CODIFIED THE LOSS CAUSATION REQUIREMENT IN THE PSLRA TO HELP CURB VEXATIOUS PRIVATE SECURITIES CLASS ACTIONS AGAINST ACCOUNTING FIRMS AND OTHERS

Although private securities suits play an important role in regulating the securities markets and compensating defrauded investors, the abusive potential of such litigation, particularly

class actions, has long been acknowledged. "There has been a widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 743, 739 (1975). Plaintiffs in such cases have found that defendants – especially secondary actors like accounting firms – can often be compelled, "as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver*, 511 U.S. 164, 189 (1995). Strike suits have been a perpetual concern for financial service professionals because "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of proportion to its prospect of success at trial * * *." *Blue Chip Stamps*, 421 U.S. at 740.

The problem of vexatious 10b-5 class actions became especially acute in the late 1980s and early 1990s, a time when private securities litigation had become more frequent and more costly. To address what majorities in both political parties had come to see as a system "seriously out of balance," Congress enacted the PSLRA in 1995. Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995, Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAWYER 1009, 1009 (1996). The statute codified the private right of action for securities fraud and imposed important restrictions on its use. Its chief purpose was to curb abusive practices in private securities litigation:

> [T]he evils flowing from abusive securities litigation start with the filing of the complaint and continue through to the final disposition of the action. A complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence. A drop in a public company's stock price, a failed product development project, or even unpredictable adverse market conditions

> that affect earnings results for a quarter can trigger numerous securities fraud lawsuits against a company.

S. Rep. 104-98, at 8 (June 19, 1995). Of particular concern was the use of frivolous lawsuits to coerce defendants to settle in order to avoid the exorbitant costs of litigation. See *Behlen* v. *Merrill Lynch*, 311 F.3d 1087, 1090-91 (11th Cir. 2002) (citing H.R. Rep. No. 104-369, at 31 (Nov. 28, 1995)); *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999) ("The enactment of the PSLRA in 1995 marked a bipartisan effort to curb abuse in private securities lawsuits, particularly the filing of strike suits.").

Certified public accountants proved particularly vulnerable to this onslaught. Although CPAs perform a variety of services for their clients, they face litigation most frequently in connection with their role as auditors of public companies' financial statements. See John Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1931 (1988). In the typical case, plaintiffs claim that the auditor's unqualified opinion on the company's financial statements induced them to invest.

Allegations of this kind in the early 1990s saddled the largest accounting firms with litigation expenses of more than three-quarters of a billion dollars and exposed them to potential liability in the untold billions. Indeed, one major firm, Laventhol & Horwath, failed as a result. See John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BOSTON U. L. REV. 301, 318 n.51 (2004). As this Court has observed, "[l]itigation under 10b-5 * * * requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Central Bank of Denver*, 511 U.S. at 189 (noting statements in the congressional record that in 83% of 10b-5 cases major accounting firms pay $8 in legal fees for every $1 paid in claims). Congress took careful note of these trends when it passed the PSLRA. See S. Rep. 104-98, at 21 ("Accounting firms particularly have been hard hit by securities litigation."); see also *ibid.* (noting that

when "peripheral defendants are sued, the pressure to settle is overwhelming – regardless of the defendant's culpability").

To help protect against these dangers, the PSLRA imposed a "strong pleading requirement" for 10b-5 actions, which included the express codification of the loss causation requirement. S. Rep. 104-98, at 15; see generally Phillips & Miller, 51 BUS. LAWYER at 1018-29 (describing the harmful effects of class action securities litigation that led Congress to enact the PSLRA). Section 21D(b)(4) of the Act thus provides that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). As we explain below, however, the Ninth Circuit's decision in this case fails to take this requirement seriously as an independent element of Rule 10b-5. Moreover, by allowing plaintiffs to satisfy loss causation even where they cannot meaningfully connect the alleged fraud with any economic injury that they have suffered, that decision significantly undermines the PSLRA's goal of reducing vexatious securities fraud litigation.

II. THE NINTH CIRCUIT'S UNDERSTANDING OF LOSS CAUSATION IS INCONSISTENT WITH THE PSLRA

Although the PSLRA has been law for nearly a decade, few courts have paid serious attention to the statute in applying the loss causation requirement. The Ninth Circuit's opinion in this case is a perfect example; in discussing loss causation, the court never mentions the PSLRA, choosing rather to focus on cases that either ignore the statute or were decided before it was enacted. See Pet. App. 8a-9a (citing *Knapp* v. *Ernst & Whitney*, 90 F.3d 1431, 1437-38 (9th Cir. 1996); *McGonigle* v. *Combs*, 968 F.2d 810 (9th Cir. 1992)). This omission is unfortunate, as a careful analysis of the statute confirms that the approach adopted by the court of appeals is indefensible, for at least two independent reasons.

A. The "lookback" provision of the PSLRA confirms that loss causation cannot consist merely of purchase-time inflation

First, the Ninth Circuit's understanding of loss causation is inconsistent with the so-called "lookback" provision, which limits damages in 10b-5 actions in which, as here, "the plaintiff seeks to establish damages by reference to the market price of a security." 15 U.S.C. § 78u-4(e)(1). In such cases

> the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

Ibid. This provision makes clear that damages in a securities fraud case such as this one do not accrue at the time of the purchase, but instead are measured based upon fluctuations in the price of the security that accompany a corrective disclosure.[2] In turn, it is clear from the PSLRA's loss causation provision (Section 21D(b)(4)) that a plaintiff's "loss" necessarily derives from the same source as damages. See 15 U.S.C. § 78u-4(b)(4) (requiring the plaintiff to show that the fraud "caused the *loss* for which the plaintiff seeks to recover *damages*") (emphases added).

The PSLRA thus expressly hitches damages to post-transaction fluctuations in the price of the security – and, in turn, links the loss causation requirement directly to damages. That is, because plaintiffs may recover damages in an amount limited by events following a corrective disclosure, it follows

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[2] Like the fraud-on-the-market presumption, the lookback provision relies on the notion that efficient markets synthesize relevant public information in pricing stocks. It thus assumes that in the absence of a corrective disclosure, any artificial valuation caused by the fraud will continue to be reflected in the price of the security.

that the "loss" for which those damages provide compensation must similarly be defined by what happens once the alleged fraud is finally revealed. Indeed, in this respect the statute rejects the very premise of the Ninth Circuit's decision: that a plaintiff's loss (and thus his damages) can be measured at the time that he purchases the security at issue. Instead, the statute decrees that both are to be assessed based upon the market's reaction to a corrective disclosure that brings the fraud to light.

So understood, the lookback rule works in tandem with the loss causation provision to further Congress's goal of tightening the substantive and procedural requirements for private securities litigation. The former fixes the maximum damages that the plaintiff may recover, while the latter insists that plaintiffs may obtain *only* the portion of that maximum that was actually attributable to the defendant's fraud. The Ninth Circuit's approach, which decouples plaintiffs' "loss" from the damages they are eligible to receive, is entirely inconsistent with this scheme.

B. The Ninth Circuit's decision undermines the unity of the PSLRA by creating two different definitions of loss causation

Nor can the decision below be reconciled with Section 105 of the PSLRA. Section 105 amended Section 12 of the Securities Act of 1934, 15 U.S.C. § 77l(a), by giving defendants in cases brought under that provision an affirmative defense of loss causation.[3] See 15 U.S.C. § 77l(b). This defense allows the defendant to show that "any portion or all of the amount recoverable * * * represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted." *Ibid.* Any such portion or amount not

[3] Section 12 confers a private right of action against those who, under certain circumstances, make false or misleading statements in connection with the sale of securities.

traceable to the false statement "shall not be recoverable." *Ibid.*[4]

Section 105 thus expressly defines "loss causation" as that which links the defendant's false statements and the "depreciation in value of the subject security." In other words, the PSLRA views loss causation as the device that distinguishes those portions of a security's post-transaction decline that relate back to the fraud from those that do not. It asks whether there were *post-transaction factors* – unrelated to the deceptive statements – that were actually responsible for some, or all, of the plaintiff's ultimate financial loss.

This statute's express definition further dooms the Ninth Circuit's analysis. For, if loss causation in Section 12 cases allows defendants to point to the existence of post-transaction events as reasons for the loss, loss causation in Rule 10b-5 cases should equally require plaintiffs to plead and prove the *absence* such events. In holding otherwise and defining loss causation in terms of purchase-time inflation, the court below left the same term with two fundamentally different meanings in the same statute. "This result is contrary to the basic canon of statutory construction that identical terms within an Act bear the same meaning." *Estate of Cowart* v. *Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992); see also *Sullivan* v. *Stroop*, 496 U.S. 478, 484 (1990); cf. *United Savings Ass'n* v. *Timbers of Inwood Forest Assocs.*, 484 U.S. 265, 371 (1988) (noting that a provision that may seem ambiguous in one context is often clarified "by the remainder of the statutory scheme – because

[4] The same loss causation defense has long existed in cases brought under Section 11 of the Securities Act of 1934, 15 U.S.C. § 77k(e)(3). See *Akerman* v. *Oryx Communications, Inc.*, 810 F.2d 336 (2d Cir. 1987) (defendant may reduce his liability by "proving that *the depreciation in value* resulted from factors other than the material misstatement in the registration statement") (emphasis added). And it is well accepted that the "causation analysis under § 11 is essentially the same as Rule 10b-5's proximate cause element." *Rebenstock* v. *Deloitte & Touche*, 907 F. Supp. 1059, 1065 (E.D. Mich. 1995).

the same terminology is used elsewhere in a context that makes its meaning clear").

III. THE DECISION BELOW IMPROPERLY CONFLATES LOSS CAUSATION WITH TRANSACTION CAUSATION

The PSLRA's definition of loss causation is entirely consistent with the Rule 10b-5 case law that had evolved prior to the statute's enactment. As long as loss causation has existed, it has been understood as a separate and distinct element from that of transaction causation. A 10b-5 plaintiff must satisfy *both* in order to recover. See *Burke* v. *Jacoby*, 981 F.2d 1372, 1378 (2d Cir. 1992); *Arthur Young & Co.* v. *Reves*, 937 F.2d 1310, 1327-28 (8th Cir. 1991); *Currie* v. *Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988). Transaction causation asks what caused the plaintiff to invest in the first place; loss causation asks what caused the investment to lose money. In derogation of this longstanding separation – as well as the express codification of loss causation as an independent requirement in 10b-5 cases – the decision below impermissibly conflates these two requirements, thereby stripping loss causation of its independent force in fraud-on-the-market securities fraud cases such as this one.

In *Basic Inc.* v. *Levinson*, 485 U.S. 224, this Court held that, under certain circumstances, private plaintiffs in cases brought under 10b-5 are entitled to a rebuttable presumption that they relied on public misrepresentations made by the defendant that would have led a reasonable investor to misjudge the value of the security. In this way, plaintiffs need not prove that they themselves were aware of the allegedly misleading statements made by the defendant, but can instead rely on the market's absorption of that information. The theoretical justification for this so-called "fraud-on-the-market" presumption is that efficient capital markets incorporate all relevant public information (whether that information is accurate or not) into the transaction price of the security: "Because most publicly available information is reflected in market price, an investor's

reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247.

Under the approach to loss causation adopted below, however, any plaintiff who satisfies the presumption of reliance by pleading that the defendant publicly made a false statement that may have inflated the transaction price has, *a fortiori*, satisfied the pleading requirement for loss causation as well. The Ninth Circuit's loss causation rule requires merely an allegation that "the price at the time of purchase was overstated and sufficient identification of the cause" (Pet. App. 9a). But this is nothing more than a restatement of the standard for transaction causation adopted in *Basic*. The Ninth Circuit offered no justification for a rule that merges the two requirements in this way, despite the fact that such an approach has been repeatedly rejected by other circuit courts. See *AUSA Life Ins. Co.* v. *Ernst and Young*, 206 F.3d 202, 216 (2d Cir. 2000) ("Loss causation is a separate element from transaction causation, and, in situations such as the instant one, loss causation cannot be collapsed with transaction causation."); *id.* at 226 (Jacobs, J., concurring) ("Loss causation requires the plaintiffs to prove more than simply that E&Y induced them to enter into an ultimately unsuccessful investment. Such a 'but-for' analysis would collapse loss causation into transaction causation."); *Robbins* v. *Kroger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (refusing to use the *Basic* presumption "to alter the loss causation requirement" because that theory "is used to support a rebuttable presumption of reliance, not a presumption of causation"); cf. *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 547 (5th Cir. 1981) (it is "a nonsequitur to conclude that the representation that induced action necessarily caused the consequences of that action").

By ignoring these well-established principles, the Ninth Circuit has created a serious tension with the PSLRA's express codification of that element. The result is to deprive CPAs (and others) of a crucial safeguard that Congress intended them to have against inventive plaintiffs' lawyers who are able to find

an arguable violation of professional accounting and auditing standards (as explained below, this is not difficult in light of the nature of those standards), but who are not able to show that the eventual revelation of the violation made any difference to the value of their clients' investments.

In so doing, the Ninth Circuit upended the traditional focus of the loss causation requirement on events occurring *after* an investor purchases a security. (In contrast to transaction causation, which focuses on purchase-time events.) The purpose of that post-transaction focus was to emphasize that not every instance in which fraud may have induced an investor into purchasing securities is actionable under Rule 10b-5. See *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990). By permitting loss causation to be satisfied solely on the basis of purchase-time events, the decision below makes it irrelevant that intervening forces unrelated to the fraud may actually have caused the investment to lose money. The consequences of such a holding are unfortunate:

> After any drop in price – even if * * * it is entirely unrelated to defendant's conduct – a subsequently dissatisfied investor would be able (with the benefit of hindsight) to point to any allegedly misleading positive statement issued by anyone * * * and couple that with an allegation that the price of the security was inflated as a result to satisfy loss causation. To allow such a claim would invite self-serving testimony, strike suits and protracted discovery.

In re Merrill Lynch & Co. Research Reports Securities Litig., 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003).

Finally, the Ninth Circuit's holding conflicts with the central premise of the fraud-on-the-market doctrine. The presumption that this Court endorsed in *Basic* rests on the premise that an efficient market incorporates public misrepresentations into the price of the security at the time of the investment. See 485 U.S. at 246 ("[T]he market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."). By the same token, until an

alleged misrepresentation is corrected and the market learns the truth, any artificial inflation will remain in the price of the stock. So long as the market continues to believe the alleged falsehood, the market will continue to (over)value the stock accordingly.

This means that unless and until the misinformation is publicly corrected, investors – even those who may have paid "too much" – have not actually been injured by that misrepresentation. The investors can simply sell on the market and thereby recover the amount that they overpaid. See *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."); *In re Initial Public Offering Securities Litig.*, 297 F. Supp. 2d 668, 672-73 (S.D.N.Y. 2003) ("So long as the amount of inflation is constant, artificial inflation causes no loss for customers who buy and sell at inflated prices."). As such, the decision below distorts the loss causation requirement by inexplicably describing as a "loss" an inflationary premium that may still belong to the plaintiff. A recovery of damages under those circumstances would represent a pure windfall justified by no plausible conception of corrective justice.[5]

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[5] Take an obvious example. An investor purchases a stock that should be worth $50 a share at an artificially inflated price of $70 based on false financial statements that overstate the company's earnings. The market never learns of the falsity in the financial statements and so the share price remains at $70. The next day, an earthquake destroys the company's main factory and its stock price drops to $60. The Ninth Circuit's approach would allow the investor to satisfy loss causation based on the purchase-time "inflation," even though that disparity remains in the stock price and could readily be recovered by selling the shares. Allowing recovery under those circumstances is both economically and legally unjustifiable: the plaintiff has suffered no economic loss that actually related to the defendant's misrepresentations, except in the but-for (and thus legally insufficient)

For these reasons, the deflation of the inflationary effect – generally through a corrective disclosure – is an essential aspect of loss causation that the plaintiff must plead to survive a motion to dismiss and must prove in order ultimately to prevail. It cannot merely be assumed away as the court of appeals did in this case. Thus, where (as here) plaintiffs are allowed to satisfy the transaction causation requirement based on the inflated stock price attributable to the alleged misrepresentation, they should be precluded from satisfying loss causation unless and until they allege and show that the price correspondingly deflated once the truth came out. See *Robbins*, 116 F.3d at 1448 (requiring evidence that the "price inflation was removed from the market price"). The Ninth Circuit's rejection of that requirement means that, in an auditing case, plaintiffs could recover from a CPA for *any* downturn in the value of their investment, regardless of whether that fall was actually caused by the alleged defects in the audit report. Such limitless recovery would effectively convert auditors into insurers, strictly liable for whatever ill-fortune besets investors in the audited company.

IV. THE NINTH CIRCUIT'S UNDULY BROAD DEFINITION OF LOSS CAUSATION IMPOSES EXCEPTIONAL BURDENS ON ACCOUNTING FIRMS ENGAGED IN AUDIT WORK

Ensuring that the loss causation requirement is applied correctly is of paramount importance to the AICPA and its members. As explained above, the weakened form of loss causation adopted by the court below undermines the PSLRA's express goal of preventing vexatious private securities litigation by relieving plaintiffs of any burden of showing that their investment loss was actually caused by the alleged fraud. By misconstruing that requirement as it did, the Ninth Circuit gutted a critical 10b-5

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sense that is already captured by the fraud-on-the-market presumption. This simply is not an acceptable view of loss causation.

element designed to separate truly victimized investors from opportunistic ones.

This is an especially serious problem for certified public accountants. Under the Ninth Circuit's rule, any CPA responsible for auditing the financial statements of a company whose stock subsequently declines faces liability to a set of plaintiffs who may not be able even to allege – much less prove – that the decline was *in any way* related to the auditor's actions. And, given the expense of discovery and litigation in securities fraud class actions, and the threat of crippling jury verdicts from those that do go to trial, the pressure to settle cases that are not dismissed early on can become enormous. See *Blue Chip Stamps*, 421 U.S. at 740. This means that accounting firms – which often are targeted as defendants because others more directly responsible for the alleged fraud have become judgment-proof – may be compelled to compensate plaintiffs even though there is no meaningful connection between the plaintiffs' loss and any auditing errors that may have been committed.

A. The highly judgmental nature of financial statement auditing makes violations easy to allege and difficult to rebut

These risks are especially severe in light of the nature of financial statement auditing. Federal law requires that many categories of financial statements, including those submitted in connection with a publicly traded company's annual report, be reviewed by an independent auditor. See *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 810-11 (1984). Auditing is an analytic process designed to "add[] credibility to the information communicated by the accounting process." DOUGLAS R. CARMICHAEL, ET AL., AUDITING CONCEPTS AND METHODS 10 (6th ed. 1996) [hereinafter AUDITING CONCEPTS]; see also *Arthur Young*, 465 U.S. at 819 n.15 ("The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries.").

It is essential to distinguish the auditing of corporate financial statements from the job of actually preparing them. Responsibility for the latter lies in the hands of a company's management. See AUDITING STANDARDS, AU § 150.02. The role of an outside auditor, in turn, is to provide an independent, professional opinion as to whether those financial statements fairly present the company's financial position in conformance with Generally Accepted Accounting Principles (GAAP). See *Edenfield* v. *Fane*, 507 U.S. 761, 769 (1993). GAAP encompasses all the conventions, rules, and procedures that collectively define accepted accounting practices at a particular time. See CARMICHAEL, AUDITING CONCEPTS 10. It derives from a number of sources, including standards promulgated by AICPA and the Financial Accounting Standards Board (FASB), prevalent industry practice, as well as expert literature. The purpose of GAAP is to provide those who prepare financial statements with the professionally acceptable way (or ways) to account for a given transaction.

As this Court has recognized, however, GAAP is "far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions." *Thor Power Tool* v. *Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1978). Quite the contrary,

> GAAP changes and, even at any one point, is often indeterminate. "[T]he determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all principles." There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. When such conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow.

Shalala v. *Guernsey Mem. Hosp.*, 514 U.S. 87, 101 (1995) (quoting R. KAY & D. SEARFOSS, HANDBOOK OF ACCOUNTING AND AUDITING, ch. 5, at 7 (1994 Update)). In addition to being multifaceted and indeterminate, much of GAAP amounts to

little more than "aspirational norms." *Bily* v. *Arthur Young & Co.*, 3 Cal. 4th 370, 380, 834 P.2d 745, 750 (Cal. 1992). Because the relevant guidelines may be stated at an extremely high level of generality, the claim that a violation has occurred is often easy to make and difficult to refute.

These are the complex criteria against which auditors are expected to evaluate corporate financial statements. To determine whether a set of statements complies with GAAP, certified public accountants rely on a variety of tests and procedures consistent with Generally Accepted Auditing Standards (GAAS). These standards define a range of procedures that a CPA may perform in the course of performing an audit. "The basic function of an audit under GAAS is to allow the auditor to formulate an opinion as to whether the financial statements present fairly the data with which the auditor has been presented." Michael R. Young, *The Liability of Corporate Officials to Their Outside Auditors for Financial Statement Fraud*, 64 FORDHAM L. REV. 2155, 2162-63 (1996).

Historically, the AICPA has had primary responsibility for developing GAAS. GAAS comprises ten core auditing standards, adopted by the membership of the AICPA in 1948 and 1949, and revised by the Auditing Standards Board (ASB). See CARMICHAEL, AUDITING CONCEPTS 13. In addition, the ASB has developed and issued 101 Statements on Auditing Standards (SAS) through a process involving public comment. See SAS No. 95, Codification of Statements on Auditing Standards, AU § 105.03 (AICPA 2002).[6] GAAS also requires auditors to be aware of and consider certain AICPA interpretive

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[6] These basic auditing requirements are quite broad and open-ended. For example, according to General Standard 3, "[d]ue professional care is to be exercised in the performance of the audit and the preparation of the report." Similarly, Field Work Standard 2 provides: "A sufficient understanding of the internal ntrol structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." CARMICHAEL, AUDITING CONCEPTS 13.

publications, including AICPA's guides and statements of position, as well as publications interpreting the SAS. Professional publications such as journals and textbooks round out this hierarchy and provide somewhat more detailed (although less authoritative) guidance to auditors in the field. See *id.*; see generally Roger Buffington, *A Proposed Standard of Common Law Liability for the Public Accounting Profession*, 5 S. CAL. INTERDISCIPLINARY L.J. 485, 489-90 (1997). Under Section 103 of the Sarbanes-Oxley Act of 2002, Pub. L. 107-204 (July 30, 2002), authority to issue Professional Auditing Standards governing CPAs in the preparation and issuance of audit reports was conferred upon the Public Company Accounting Oversight Board (PCAOB). See 15 U.S.C. § 7213.[7]

It is important to note that even audits performed in full compliance with GAAS cannot guarantee that every problem lurking in the financial statements will be discovered. Because it is impossible to evaluate every single transaction, even for a small business, auditors invariably rely on sampling techniques to test the accuracy of financial statements. See Robert W. Berliner, *Audit Reports*, 440 PRACTICING LAW INSTITUTE Lit. 41, 55 (July-August 1992). "Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." SAS No. 39 (AU 350.01); see also *Bily*, 834 P.2d at 749 (noting that "an audit rarely, if ever, examines every financial accounting transaction in the records of a business"). The test nature of financial auditing, although essential to the process, does decrease the reliability of an audit as, by definition, it means that some errors in a given set of financial statements may go unreviewed and thus undetected.

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[7] The PCAOB is a private, non-profit corporation created by the Sarbanes-Oxley Act to supervise and regulate the auditing of public companies. Although not an agency of the federal government, 15 U.S.C. § 7211(b), PCAOB is overseen by the SEC, which appoints its chairman and members. See *id.* at § 7211(e).

This challenge is compounded by the fact that outside auditors must rely heavily on the financial data provided by the audited company. Audits are, by their very nature, conducted in an environment largely controlled by the client. See *Bily*, 834 P.2d at 762. Although it is appropriate for CPAs to maintain a degree of professional skepticism about the information they are given, and not blindly accept the representations of management, it is simply not possible for an auditor to unearth any and all misleading assertions that the company includes in its financial statements. "An auditor is a watchdog, not a bloodhound." *Bily*, 834 P.2d at 762.[8]

It is for these reasons that CPAs do not certify that audited financial statements are accurate. The audit report instead states that in the opinion of the auditor the statements are a "fair representation" or ("fairly present") the actual financial position of the audited company. The issuance of an unqualified (*i.e.* clean) audit report – even one that satisfies all of the requirements of GAAS – does not and cannot "ensure or

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[8] In October 2002, amidst the recent corporate and accounting scandals, the ASB promulgated a new auditing standard for addressing potentially fraudulent financial statements. See SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, AU § 316. The purpose of this new standard was to shift the focus of financial auditing more to the detection and prevention of management fraud. This corresponds with the duty previously imposed on auditors by the PSLRA to take steps to increase the likelihood of detecting fraud. See 15 U.S.C. § 78j-1(a) (audits of financial statements must include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statements amounts"). Even under this standard, however, the auditor is required only to obtain "reasonable assurances" that fraud has not occurred. SAS No. 99 recognizes that, given the nature of fraud – and of financial auditing – even a perfect audit will not necessarily expose concealed chicanery on the part of corporate managers. See Sally L. Hoffman, *The CPA's Professional Standards: What Are They? Who Sets Them? What Are the Key Issues Today?*, SJ077 ALI-ABA 119, 144 (May 2004).

warrant the accuracy of the financial statements." CARMICHAEL, *supra*, at 9. Indeed, an "audit does not guarantee that a client's accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being; indeed even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect material omission or detection." *In re Ikon Office Solutions*, 277 F.3d 658, 673 (3d Cir. 2002).

Given the way in which accepted accounting principles change over time and resist being reduced to a series of bright-line rules, an auditor's application of GAAS requires an exercise of discretionary professional judgment. It does not involve the mechanical application of mathematical formulae and is closer to an art than a science. The factors that inform the auditor's judgment are numerous and complex, as are the professional standards that define a job well done. At bottom, then, an audit opinion is just that: an *opinion*. It is not – and cannot be – an objective statement of fact. See Jay Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 54 (2003) [hereinafter *Accountants' Liability*]. The California Supreme Court has aptly described this essential quality of an audit report:

> [T]he report is based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.

Bily, 834 P.2d at 763. AICPA's standards are clear about this, explicitly providing that "a properly designed and executed

audit may not detect a material irregularity." SAS 53 (§ 316.07) (AICPA 1989).

Despite these realities, however, an "expectations gap" persists between what CPAs expect of an audit and what the public (and often the courts) expect. See Richard I. Miller & Michael R. Young, *Financial Reporting and Risk Management in the 21st Century*, 65 FORDHAM L. REV. 1987, 2016 & n. 129 (1997). This gap contributes to an environment in which investors are likely to blame auditors for unforseen corporate collapses and to sue them when they occur. The allegation that a CPA ran afoul of some aspect of the general rules of GAAS or failed to identify one of the myriad potential GAAP violations is easy to make and difficult to rebut. Courts routinely invoke such alleged violations in sustaining claims against auditors. See, *e.g.*, *Rhode Island Hosp. Trust Nat'l Bank* v. *Swartz*, 485 F.2d 847, 852 (1st Cir. 1972); *In re Anchor Communications, Inc.*, 22 F. Supp. 2d 999, 1005-06 (D. Minn. 1998); *In re Miller Indus., Inc.*, 12 F. Supp. 2d 1323, 1332 (N.D. Ga. 1998). Especially in a declining market, where the bursting of a bubble leaves many investors with significant losses, bringing suit against an auditing firm based on an allegedly deficient audit can be an easy way to try to recoup those losses. And the Ninth Circuit's loose approach to loss causation wrongly allows such suits to go forward unimpeded.

B. Because auditors are especially vulnerable to vexatious securities class actions, they will be greatly harmed by the weakened loss causation rule adopted by the Ninth Circuit

In addition to the expectations gap, there are other reasons why CPAs are inviting targets for expansive notions of securities fraud liability. In the wake of a corporate failure, the auditor is often the last one standing. In many cases, the issuer responsible for the allegedly misleading financial statements has gone bankrupt or become otherwise judgment-proof, leaving the CPA as the only entity from which plaintiffs can hope to recover their investment losses. See Daniel L. Brockett, *Line*

Between Primary and Secondary Liability Still Blurred in Securities Cases, 50 FED. LAWYER 29, 30 (Aug. 2003). Indeed, between 30 and 40 percent of securities fraud cases against auditors involve companies that are in, or about to enter, bankruptcy. See Zoe-Vonna Palmorose, *Who Got Sued?* J. OF ACCOUNTANCY ONLINE (March 1997), available at www.aicpa.org/pubs/jofa/march97/whosued.htm. Thus, despite having played a secondary role limited to testing the allegedly misleading financial statements against a complex and open-ended set of professional standards, accounting firms frequently emerge as the lone defendant financially able to satisfy a judgment. See Feinman, *Accountants' Liability* at 57.

Given their exposure to potentially vast liability, as well as their concern for their professional reputations, accounting firms may be forced to settle even where the merits of a suit are dubious. Against this backdrop, a robust loss causation requirement guards against the prospect that auditors will be made to cover investment losses for which their actions were in no way responsible. The loss causation element serves as an essential safety net for CPAs accused of fraud, one ensuring that auditors will be liable only to those investors who were actually harmed as a result of a misstated audit opinion. Unless that requirement is construed as Congress intended – as a way to force plaintiffs to plead and prove that their losses were in some meaningful way connected to the fraud about which they complain – CPAs will continue to be threatened with unchecked liability from a class of disappointed investors who do not allege, and cannot prove, that they lost money as a result of anything that the auditor said or failed to say.

The Ninth Circuit's holding in this case significantly undermines that crucial aspect of loss causation and thereby moves the securities laws closer to what they were never intended to be: a form of cost-free insurance for disappointed investors. See *Huddleston*, 640 F.2d at 549. The securities laws do not promise or deliver comprehensive investor insurance. The costs of investment losses caused by factors other than fraud must be assumed by investors, not by

professionals such as CPAs, lawyers, and market analysts. That, at any rate, was exactly the reason that Congress codified the loss causation rule when it sought to rein in private securities class actions in the PSLRA. Allowing lawsuits to proceed solely on allegations of transaction causation, which would leave CPAs vulnerable to suit in the case of *any* audit that could be alleged to have been imperfect, over-deters auditors, over-compensates plaintiffs, and fundamentally distorts the nature of Rule 10b-5. Accord *Bastian*, 892 F.2d at 685 ("No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities.").

Failure to take loss causation seriously – thereby subjecting auditors to virtually unchecked litigation exposure – has serious social and economic consequences. Securities litigation is extremely costly; one study found that it costs an auditor an average of $3.7 million to defend itself against even a weak securities fraud class action. See Palmrose, *supra*. In the years immediately preceding passage of the PSLRA, it was well documented that rampant class action litigation against CPAs under Rule 10b-5 made accounting firms increasingly unwilling to perform audits for clients perceived as risky, such as those in financial distress, smaller or less-well established companies (including start-ups), and companies operating in volatile industries such as technology. See Frederick L. Jones & K. Raghunandan, *Client Risk and Recent Changes in the Market for Audit Services*, 17 J. ACCT. & PUB. POL'Y 169, 179 (1998).[9]

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[9] Class action litigation against accounting firms did decrease in the first years after passage of the PSLRA, a trend undoubtedly helped by this Court's holding in *Central Bank of Denver*, 511 U.S. at 191, that aiding and abetting liability was not available under Section 10(b). See SEC, Office of the Gen. Counsel, *Report to the President and the*

A shrinking supply forces companies with fewer resources to endure higher prices for legally required financial audits. Such high-risk firms are particularly dependent upon the imprimatur of a well-established, well-respected auditor in order to gain the confidence of the market. Depriving them of quality auditing services makes it more difficult for the growth sectors of the economy to develop to their full potential. *Central Bank of Denver*, 511 U.S. at 189. For, even where litigation risk does not lead CPAs to forego doing audits altogether, they will typically insist on higher fees to high-risk clients, costs that audited companies will undoubtedly attempt to pass on to consumers. See Jamie Pratt & James D. Stice, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Fees*, 69 ACCT. REV. 639, 655 (1994). Empirical studies have also shown that litigation against an audit firm – even, or perhaps especially, frivolous ligation – hurts the stock price of an auditor's *other* clients. See Diana R. Franz, et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. ACCT. AUDITING & FIN. 117 (1998).

Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 22 (Apr. 1997), available at www.sec.gov/news/studies/lreform.txt. More recently, however, there has been a resurgence in litigation alleging accounting fraud and targeting CPAs. See Kevin P. Roddy, *Seven Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995* (July 24-26, 2003). In 2002, accounting-related cases represented 68 percent of all private securities class actions, up from 47 percent in 1996. Settlements in accounting cases comprised 67 percent of all securities-related settlement amounts in 2002. PriceWaterhouseCoopers LLP, *2002 Securities Litigation Survey*, at 4. It has thus been accurately observed that accounting fraud seems to have become "the 'complaint of choice' for private securities class action plaintiffs." *Ibid.* Independent auditors were named in 34 of these cases, up from 18 the previous year. In absolute terms, 2002 had the highest number of cases against auditors since 1998, when 39 cases were brought. See *id.* at 7.

Finally, the expansive approach to loss causation embraced by the Ninth Circuit gives a windfall to plaintiffs that is not necessary to ensure that potential wrongdoers are deterred. There is no reason to fear that applying the loss causation requirement correctly will somehow create a gap in the enforcement of the securities laws. First, the SEC is not required to prove either loss causation or transaction causation when it brings an enforcement action under Section 10(b). See Br. of the SEC, *Amicus Curiae*, in Support of Appellants, *Schoenfeld Asset Mgmt. Corp.* v. *Cendant Corp.*, Nos. 99-5356; 99-5355 (3d Cir. Sept. 1999), at 12; *SEC* v. *Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). The federal government thus always retains the power to take appropriate action against individuals and firms that engage in fraud proscribed by the federal securities statutes, regardless of whether any particular investors suffered financial harm as a result of that fraud. There is neither need nor reason to extend that expansive law enforcement power to private plaintiffs by redefining loss causation as the court of appeals has done in this case. Indeed, doing so potentially delegates too much enforcement power to unaccountable plaintiffs' lawyers, trenching on the SEC's prosecutorial discretion to bring suit in cases where no individual investor has suffered an injury fairly traceable to the alleged fraud.

Separate and apart from SEC enforcement, the auditing of public companies subject to the securities laws is now monitored and regulated by the PCAOB. The Board is charged with overseeing audits "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." 15 U.S.C. § 7211(a). The Board has broad supervisory and regulatory powers over auditors and is empowered to investigate and bring disciplinary charges against accounting firms for violations of the securities laws. See *id.* at § 7215. In addition, state accountancy boards have wide-ranging disciplinary authority over the accountants whom they

license to practice. This thorough supervision of public company accounting practices both demonstrates the lack of need for a relaxed loss causation rule and raises the possibility that adopting such a rule will lead to excessive regulation through private litigation in which plaintiffs cannot meaningfully connect the loss they suffered with the auditor's actions.

CONCLUSION

For the foregoing reasons, the judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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